The Manufacturers Hanover
Economic Report

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NOVEMBER 1981

The Tip of the Iceberg

Seeing the apparent inability of the Administration to reduce the Federal Government's budget deficit, a number of observers have begun to belittle its impact on the economy. Comments to this effect have originated from such disparate sources as the financial press, academia — and even from the Administration, itself. In my view, Washington's inability to balance its books is even more important than it appears. This is because the reported deficit is but the tip of the Federal financing iceberg. And like the real thing, what you don't see can hurt you every bit as much as what you do see, if you hit it.

Right now, the economy is reeling because the credit markets have slammed into this iceberg. Although they have retreated in recent weeks, interest rates are still high — especially when you take the rate of inflation into account. The level to which real interest rates rose this past summer was enough to cause a rapid runup in business failures and unemployment along with a steep decline in economic activity.

In their search for a villain, a number of observers both in and out of government have sought to blame Wall Street for talking itself into high interest rates and low stock prices. They point out that the deficit alone should be little cause for concern since it amounts to a relatively small percentage of the gross national product compared with earlier years. The point is also made that our budget deficits look relatively small by international standards. Finally, there are those who aggressively assert that there is no evidence linking budget deficits to either money growth, inflation or interest rates.

Supply And Demand

Those who attack Wall Street would certainly realize, if they thought for a minute, that investors, traders and even speculators don't deliberately want to see themselves go to the poorhouse. As much as they would like to see the financial markets rally, the demand for funds is so much greater than their supply that it prevents such a salutory development from occurring. In particular, the demand for money from Washington is even greater than the reported budget deficit indicates. This means that even if Washington were to make some progress in reducing its deficit, the financial markets would not necessarily jump for joy. For the Government regularly raises funds that are not reflected in either the budget deficit or in the national debt (the accumulated total of each year's budget deficit or surpluses). What the markets are saying is that the deficit is a symbol of a much larger Federal government presence in the marketplace, and if Washington cannot control the visible portion, how can it be expected to reduce the portion that lies beneath the surface, away from public scrutiny?

Table 1
FEDERAL AND FEDERAL-RELATED BORROWINGS
($ billions)

Fiscal Year	Direct Treasury*	+ Federally-Sponsored Enterprises	+ Guaranteed Loans	= Total Federal and Federal-Related Borrowings
1960	2.2	0.4	3.0	5.6
1961	1.4	−0.3	5.0	6.1
1962	9.8	1.1	4.1	15.0
1963	6.1	0.4	5.5	12.0
1964	3.1	1.9	4.2	9.2
1965	4.1	1.2	5.2	10.5
1966	3.1	1.8	4.1	9.0
1967	2.8	−3.9	2.1	1.0
1968	23.1	2.6	5.6	31.3
1969	−1.0	3.1	9.0	11.1
1970	5.0	11.0	1.9	17.9
1971	19.4	−2.1	16.1	33.4
1972	19.4	0.7	19.8	39.9
1973	19.3	10.6	17.7	47.6
1974	3.0	10.9	10.5	24.4
1975	50.9	5.3	8.7	64.9
1976	82.9	4.1	11.2	98.2
1977	53.5	12.0	14.0	79.5
1978	59.1	21.4	13.9	94.4
1979	33.6	21.9	26.1	81.6
1980	70.5	21.4	32.4	124.3
1981 (e)	75.4	27.8	51.3	154.5

* Borrowings to finance both on- and off-budget (primarily Federal Financing Bank) outlays.
Source: Treasury Dept.

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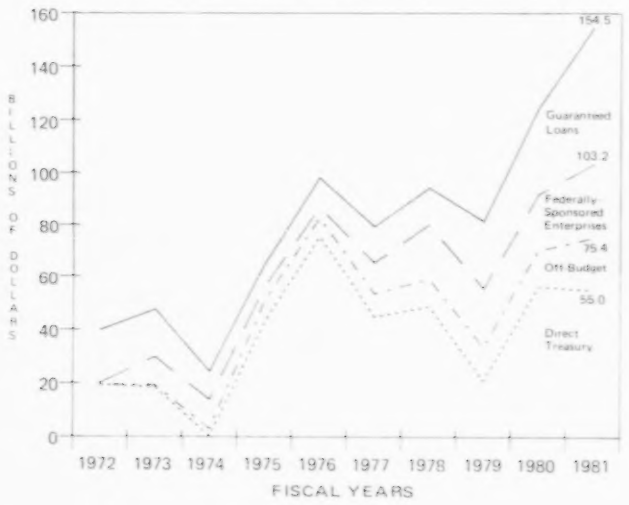
In order to see the true nature of Washington's presence in our capital markets, it is necessary to change the fraction that people so commonly look at (the ratio of deficits, or debt, to the GNP). What I will describe below will, in effect, enlarge the numerator while shrinking the denominator.

A Distorted View

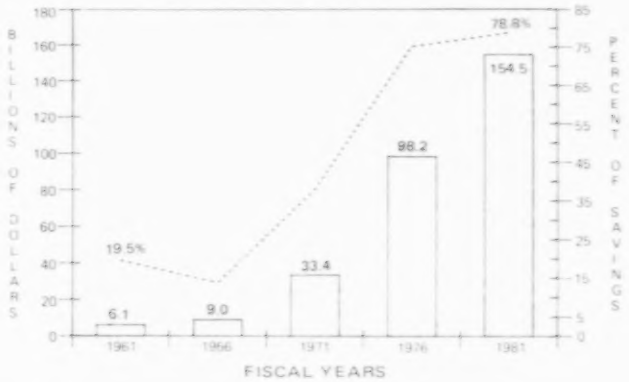
Since 1973 the reported budget deficit has provided an increasingly distorted picture of trends in Federal finance. This is because of the numerous "off-budget" programs that have proliferated in recent years. For example, in addition to financing fiscal year 1981's budget deficit of about $58 billion, the Treasury also raised some $17 billion "off the books," so to speak, through the activities of the Federal Financing Bank. Created at the end of 1973 and commencing operations in 1974, the FFB (which possesses unlimited borrowing authority at the Treasury) is authorized to purchase the debt and loan assets of such on-budget agencies as the Export-Import Bank and the Farmers Home Administration. Additionally, such entities as the Postal Service, U.S. Railway Association, and the Rural Electrification and Telephone Revolving Fund have regularly tapped the financial markets via the FFB for credit under Washington's umbrella — yet are not included in the official budget totals.

CHART I
COMPONENTS OF FEDERAL BORROWING



Then there are the Federally-sponsored enterprises. Such organizations as the Federal National Mortgage Association, Banks for Cooperatives, Federal Intermediate Credit Banks, Federal Home Loan Banks and Home Loan Mortgage Corporation and the Student Loan Marketing Association are able to borrow in the credit markets with the backing of Washington. The Congressional Budget Office estimates that these Federally-sponsored enterprises raised nearly $28 billion in fiscal year 1981 in addition to the $75½ billion that was raised to finance the on- and off-budget outlays described above. Table I shows how these enterprises have increased dramatically their fund-raising over the past two decades. Also shown on Table I is a third column depicting guaranteed loans. Six years ago, in 1975, less than $9 billion worth of guaranteed loans existed. In fiscal year 1981, that number amounted to over $51 billion! To be sure, the Federal Government does not actually borrow this money itself, but its guarantee enables another borrower to move to the head of the line, in effect, pushing others in the credit market to the rear.

CHART II
TOTAL FEDERAL BORROWING (BAR) VS.
TOTAL FEDERAL BORROWING
AS A PERCENT OF SAVINGS (DOT)



What all this means can be discerned from a look at the last column in Table I — Total Federal and Federal-related borrowings. As you can see, it is the sum total of direct Treasury, Federally-sponsored enterprises and guaranteed loans. The Treasury Dept. estimates that this total exceeded $154 billion in 1981. By contrast, it was $98 billion in 1976, $33½ billion in 1971, $9 billion in 1966 and a little more than $6 billion 20 years ago. Chart I shows how this total has grown since the early 1970s — especially those portions of Federal government involvement in the credit markets that don't show up in the budget.

It's Savings That Count

But this is only a part of the story. The denominator of the fraction must be restated as well — only in this case, made smaller. Many people tend to look at the size of either deficits or the total debt outstanding relative to the size of the economy and claim that the government's red ink is not a problem. It is true that the current deficit is running about two per cent of the GNP compared with 2⅓ per cent in fiscal 1980 and almost 3½ per cent in the 1975-76 period. It is also true that our budget deficits are small in comparison with other countries. Finally, it is also a fact that following World War II, the national debt

outstanding amounted to three times the size of the gross national product whereas today, even at the enormous sum of $1 trillion, it is only about one-third of the GNP.

All of these statements, however, fail to take into account the fact that it is not a country's gross national product that is called upon to finance these deficits. Rather, it is its stock of savings that must do the job. According to the Federal Reserve Board, the economy generated about $196 billion in savings in 1981, reflecting business-related earnings, personal savings, and state and local pension fund contributions. This was up a healthy 15 per cent over 1980—but it occurred at a time when Federal and Federal-related borrowings rose 24 per cent. This one-year trend typifies the experience that the economy has undergone over the past two decades as you can see from Table II and Chart II. The financing required by Federal and Federal-related borrowings in fiscal year 1981 took nearly 79 per cent of available savings. This compares with 75 per cent in 1976, 38 per cent in 1971, and 16¾ per cent in 1966 and in 1961 combined.

Table II

FEDERAL AND FEDERAL-RELATED BORROWINGS VS. TOTAL SAVINGS

Year	(1) Net National Savings* (Billions of Dollars)	(2) Federal and Federal-Related Borrowings** (Billions of Dollars)	Federal and Federal-Related Borrowings As A Percent Of Total Savings
1960	29.0	5.6	19.3
1961	31.3	6.1	19.5
1962	38.6	15.0	38.9
1963	38.3	12.0	31.3
1964	47.6	9.2	19.3
1965	58.2	10.5	18.0
1966	65.4	9.0	13.8
1967	70.4	1.0	1.4
1968	69.4	31.3	45.1
1969	64.8	11.1	17.1
1970	70.1	17.9	25.5
1971	87.8	33.4	38.0
1972	102.1	39.9	39.1
1973	118.1	47.6	40.3
1974	100.4	24.4	24.3
1975	110.6	64.9	58.7
1976	130.8	98.2	75.1
1977	168.3	79.5	47.2
1978	177.0	94.4	53.3
1979	174.8	81.6	46.7
1980	169.9	124.3	73.2
1981	196.0	154.5	78.8

(1) Calendar Year

(2) Fiscal Year

* *Total savings* equals gross private savings (corporate and household), plus state and local government surpluses and capital grants received by U.S. less net foreign investment and capital consumption allowances

** *Federal and Federal-related borrowings* are the sum of direct Treasury borrowings, Federally-guaranteed loans and borrowing by Federally-sponsored enterprises.

Sources: Federal Reserve; Treasury Dept., MHT Co.

Let me knock down a couple of other arguments as well. There *is* a relationship between Federal borrowing and the money supply. Over the past dozen years, the Federal Reserve has expanded the money supply as the Federal government's borrowing has preempted more and more of national savings. And, as you might expect, since excess growth in the money supply has been identified as a basic cause of inflation, there is also a discernible relationship between Federal borrowings and the rate of inflation.

Of course, the Federal Reserve is no longer following a policy of replacing the funds that the Federal government borrows in an effort to hold interest rates down and make funds available for private-sector borrowers. The Central Bank has switched from trying to manage interest rates, to attempting to control the growth of the money supply. While this may seem necessary to curb inflation, it does limit the amount of funds available to the private sector as long as Washington borrows heavily.

Is There Any Hope?

Going through this exercise makes it very difficult to come up with any kind of an optimistic conclusion over where this economy is headed. If this Administration cannot eliminate the visible budget deficit, who else will be able to do it? Additionally, since more and more Federal government credit demands take place in ways that are not measurable in the budget but certainly are felt in the financial markets, how will these activities be brought under control? That they have to be brought under control there is no doubt. For if they are not, more and more of national savings will be preempted by Washington. This will cause interest rates to remain high, the economy to remain depressed and our potential to compete in world markets to become seriously diminished.

Are we going to accept this, or are we ready to start scaling back the scope of government to not only do more for ourselves, but do it in a more efficient way, in a climate of less inflation and lower interest rates? Only time will tell. H

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